Nonprofit Finance Fund®

Critical steps toward capital health in the cultural sector

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Strong capitalization provides organizations with creative freedom, while weak capitalization compromises artistic dreams.

Too many cultural groups are troubled by unhealthy finances, reflected in uneven cash flow, few or no reserves, aging or under-resourced facilities and insufficient funds for program innovation and improvements in business practice. These widespread conditions impede the ability of cultural organizations of all kinds – from museums and orchestras to community theaters and single-choreographer dance companies – to develop and present programs that inspire people and make community life more vibrant.

Both cultural groups and their funders bear responsibility for creating this situation and both can take affirmative steps to change it.

Nonprofit Finance Fund (NFF) defines **capitalization** as the financial resources that support mission over the long term. Capitalization is revealed on the balance sheet, in the composition and magnitude of assets, liabilities and net assets. But capitalization is propelled by the **business model** – how an organization makes and spends its money in service of its mission. By generating annual surpluses, a reliably strong business model sustains a healthy capital structure which, in turn, supports dynamic cultural programming.

The principles below, developed by NFF over more than three decades of work with thousands of nonprofit groups and hundreds of funders, provide a pathway to the effective capitalization that is essential to artistic and organizational resiliency. While every organization is unique and there is no "one-size-fits-all" approach to capitalization, these principles are a decision-making guide for cultural organizations of all disciplines and sizes and funders who care about the health of individual institutions and the sector as a whole. When applied thoughtfully, in concert with strong financial planning and management, these steps offer the most direct route to building financially healthy organizations that can adapt to their changing circumstances.

FIVE KEY TIPS FOR BOTH CULTURAL ORGANIZATIONS AND FUNDERS

1. Familiarize yourself with the basics of capitalization

- Effective capitalization means having the cash necessary to execute strategy in pursuit of mission over a sustained period of time.
- All organizations require two distinct kinds of money: **revenue** for ongoing operations and **capital** to change programs, operations and/or structure.
- Investing to sustain existing programs requires a different approach than investing to grow or adjust programs and operations.
- Appropriate capitalization supports three basic financial functions: **liquidity** to address regular operating needs, **adaptability** to make necessary artistic and business adjustments; and **durability** to invest in future, long-term needs.

2. Embrace integration of financial planning with organizational and program planning

- An organization's mission and goals should drive its business model and balance sheet, not the other way around.
- Program and organizational strategy should be accompanied by a strategy and roadmap for finances.
- The strongest organizations make it a priority to increase the reliability of revenue and build financial reserves as part of their annual planning process.

3. Understand the hierarchy of financial need

- **The most pressing need for all cultural organizations is for short-term liquidity to manage cash flow cycles and absorb regular operating risk (including unexpected expenses).** Building working capital and creating operating reserves should be an organization's first capitalization priority.
- Periodic infusions of funds for artistic risk-taking and organizational change are the next pressing need of most cultural organizations. An organization's long-term viability and vibrancy depend on its understanding this need, planning for it, and securing the necessary resources.
- Board-designated reserves to support liquidity and periods of transition are usually preferable to traditional endowments. The majority of organizations never need a permanently restricted investment fund and shouldn't establish one until other capital needs have been met.

- Facilities require ongoing repair and maintenance, and all facility owners must save specifically for reinvestment in their fixed assets. Organizations must raise funds over and above operating costs to handle facility costs responsibly; those that cannot do so should not take on building ownership.

4. Get beyond break-even: manage and fund for operating surpluses

- Like people, organizations need savings to take advantage of opportunities, respond to unexpected expenses and control their destinies.
- Breaking even each year does not strengthen an organization's finances over time. The healthiest organizations develop and implement savings plans that strengthen their balance sheet each year.
- Repeatedly ask yourself these fundamental questions:

  Are budgets over-estimating what will be spent and under-estimating what will be brought in?

  Are regular surpluses contributing to savings?

  Are deficits planned, rare and temporary?

  Are reinvestments in technology, systems and facilities occurring in a timely fashion?

5. Capitalization is a way of life, not a fixed destination

- There is no "arrival point" to capitalization because business and capital needs are always evolving.
- Take manageable steps, informed by the current situation, toward stronger capitalization.
- Be patient and disciplined. The process isn't quick, but the long-term results can be transformative.

FIVE ADDITIONAL SUGGESTIONS FOR CULTURAL ORGANIZATIONS

1. Ground financial goals in the context of your market's realities

- Be realistic about the willingness and ability of audiences/visitors and donors to pay for what you do.
- Only count on earned and contributed revenue with high likelihood and reliability.
- Evaluate your revenue risks continuously, based on new market information, and adjust your financial forecast accordingly.

2. Assess and seek funding for the full costs of programs and projects

- Include realistic levels of overhead and contingencies in assessing the costs of launching, running and revamping programs.
- Be wary of starting new programs without full-cost funding in place.
- Make tough decisions about what to do and not do, based on realistic funding projections.

3. Use general operating support (GOS) and unrestricted funds to finance current operations or build savings, not to seed new projects or organizational growth

- Resist the temptation to divert your precious GOS to program expansion.
- Seek multi-year infusions of change capital to support departures from business as usual, including contraction or expansion of activity (doing less or doing more) or significant change in programs or operations (doing things differently).
- Establish risk or opportunity reserves from surpluses, or special capital fundraising, to support artistic experiments or business innovations.

4. Track and analyze progress toward mission and business goals

- Set annual program, operating and financial metrics that align with your strategy.
- Monitor progress toward these benchmarks and use data to guide course corrections. Develop scenarios before they occur: what will happen if anticipated revenue doesn't materialize or expenses exceed expectations?

5. Communicate your capitalization strategy in your financial reporting, and sell your capitalization strategy to your supporters

- Develop multi-year revenue and expense projections that map your strategy in financial terms.
- Segregate capital from operating revenue in financial reports and plans; conflating the two is likely to present an overly optimistic picture of your organization's finances.
- Prepare written, board-approved policies governing the purpose, use and replenishment of reserves.
- Supporters give to missions, not balance sheets: explain how investments in strengthening your capitalization will result in stronger artistic programs and other services for the public.

In summary, simple steps by nonprofits can propel change in the right direction. These include:

- Developing strategies that integrate financial planning with operational and program planning,
- Budgeting and managing to operating surpluses,
- Understanding and seeking funding for the full costs of projects and programs,
- Prioritizing working capital and savings for periodic risk-taking and change, and
- Clearly communicating your capitalization goals, priorities and timeline.

FIVE ADDITIONAL SUGGESTIONS FOR FUNDERS

1. Be clear about your chosen role: Are you a "buyer" (a source of ongoing revenue) or a "builder" (a source of periodic capital)?

- Funders can play one or both of these necessary roles. But each role requires a different kind of investment strategy, and both funders and organizations should be clear about the differences.
- Buyers should not have unrealistic expectations: you are supporting ongoing programs and business operations, not structural change.
- Capital investments are most successful when the organization is already generating recurring surpluses (or has a plan for how capital will be deployed en route to future surpluses); otherwise, the capital is likely to be re-purposed as regular revenue to offset routine expenses.

2. If you are a buyer (who provides revenue), fund programs and projects at full cost, supplemented by unrestricted support

- Funders who invest in program expansion without supporting related operating costs are encouraging organizations to over-extend.
- To be responsible, funders who make project grants should strive to cover their full costs, including a reasonable provision for administrative costs and savings.
- Funders can support stronger capitalization by providing flexible grants, which allow organizations to free up resources to pay for critical infrastructure or contribute to surpluses.
- By articulating and tracking the outcomes you seek rather than monitoring specific expenses, you can encourage healthier finances and programs.

3. If you are a builder (who provides capital), orient your support to the hierarchy of financial need

- Encourage and support organizations to address their liquidity needs first by prioritizing working capital to manage cash flow cycles and operating reserves to absorb regular operating risk.
- Consider funding artistic risk-taking (with risk capital) and organizational change (with change capital) once short-term liquidity needs have been met. Risk capital pays for experimentation at the project level, whereas change capital supports adjustments in program or business model at the whole organization, or enterprise level.

- Your investment of change capital gives organizations the space to develop ideas, program delivery models and capacity configurations that lead to more reliable recurring revenue net of costs. Change capital investors should support an organization's planning process, recognize that organizational adaptation is a multi-year pursuit, and be patient with experiments, setbacks and course corrections.
- If you make facility-related grants, consider seeding or adding to reserves that support their ongoing care and periodic refurbishment.
- Consider supporting unrestricted, board-designated reserves as an alternative to permanently restricted investment funds.

4. Talk about capitalization principles with organizations

- Review business models with applicants and discuss what drives revenue and expenses. Review balance sheets to understand capitalization strengths, weaknesses and needs.
- Ask applicants about their capitalization strategy, near- and long-term. Encourage honest dialogue about the need for debt reduction, working capital, longer term savings and funds for periodic risk-taking and change.
- Even if you don't provide capital, make clear how your policies and practices reinforce strong capitalization.

5. Talk about capitalization principles with other funders

- Consider pooling capital resources with like-minded grantmakers to increase the likelihood of impact.
- Initiate conversations with other funders about the capitalization condition of cultural groups in your area. Share your learning with peers to encourage changes in practice that move toward stronger capitalization.

In summary, simple steps by funders can propel change in the right direction. These include:

- Encouraging integrated planning that links program, operations and finances to strategy,
- Rewarding rather than penalizing surpluses,
- Funding projects and programs at full costs,
- Seeding reserves for liquidity, risk-taking and change, and
- Engaging in dialogue with your staff, grantees and peer funders about capitalization principles.

RESOURCES

For more detailed information about capitalization of arts and culture organizations, see:

NFF resources

- Change Capital in the Arts series: http://nonprofitfinancefund.org/case-change-capital-arts
- Investing CAPITAL for CHANGE – Ten case studies: http://nonprofitfinancefund.org/LFF/Profiles
- Capitalization Planning: http://nonprofitfinancefund.org/blog/capitalization-planning
- All Flexible Funding is Not Created Equal: http://nonprofitfinancefund.org/blog/all-flexible-funding-not-created-equal-gos-capacity-building-grants-and-change-capital
- Capitalization for Art's Sake: http://www.giarts.org/article/capitalization-art%E2%80%99s-sake
- Why Do Balance Sheets Matter?: http://www.giarts.org/article/why-do-balance-sheets-matter
- Financial Reporting Done Right: http://nonprofitfinancefund.org/research-resources/case-capital-financial-report-done-right

Additional resources

- Grantmakers in the Arts National Capitalization Project: http://www.giarts.org/article/national-capitalization-project
- Capitalization Principles in Practice: http://www.giarts.org/sites/default/files/22-1_Koo_Capitalization-Principles-in-Practice.pdf
- Getting Beyond Breakeven: http://www.tdcorp.org/pubs/capitalization_report.pdf

Nonprofit Finance Fund unlocks the potential of mission-driven organizations through tailored investments, strategic advice and accessible insights.

Helicon collaborates with artists, cultural organizations, foundations and other creative enterprises to make communities better places for all people – more vital, adaptive and just.

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